Like-Kind Exchange Proposal Is a Job Killer, Say Pros

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Real estate professionals have slammed President Biden's proposal to limit like-kind exchange treatment to gains under $500,000, saying it would kill jobs and not actually raise revenue.

"The economic impact of like-kind exchanges in their present form is a far better pay-for than eliminating this powerful stimulus," Suzanne Goldstein Baker, general counsel for Investment Property Exchange Services Inc., told *Tax Notes*.

Practitioners who specialize in real estate taxation weighed in on the section 1031 proposal included in Biden's American Families Plan, which calls for reforming the code "so that the wealthy have to play by the same rules as everyone else" to offset the cost of his ambitious expansion of subsidies for families and workers.

Describing the proposal to restrict like-kind exchange treatment under section 1031, an April 28 White House fact sheet said Biden "would also end the special real estate tax break — that allows real estate investors to defer taxation when they exchange property — for gains greater than $500,000."

The proposal wasn't unexpected, although it was unclear what form it would take. The Biden campaign signaled in July 2020 that a plan to boost the caregiving economy could be partly funded by "rolling back unproductive and unequal tax breaks for real estate investors with incomes over $400,000."

Biden had made no further comments on section 1031 after winning the presidency, but industry groups were worried enough to highlight the importance of like-kind exchanges in a March 16 letter to the leaders of Congress's taxwriting committees.

Misguided

Goldstein Baker, who is co-chair of the Federation of Exchange Accommodators? Government Affairs Committee, said Biden's proposal to limit section 1031 to gains not exceeding $500,000 "would effectively eliminate commercial real estate exchanges, as well as larger farm and ranch exchanges."

The proposal is based on a misguided view of the purpose and benefits of like-kind exchanges, Goldstein Baker said. "Section 1031 encourages real estate transactional activity, and in doing so, it is a powerful stimulator of the U.S. economy," she said.

Goldstein Baker also rejected the characterization of section 1031 as an unfair or abusive loophole, saying the provision is used by a broad range of taxpayers.

Matthew E. Rappaport of Falcon Rappaport & Berkman PLLC agreed, saying there's a misperception that section 1031 benefits only wealthy taxpayers. "I've worked on many [section] 1031 deals that fund multifamily housing, workforce housing, affordable housing," he said. "These are not high-end, luxury condos. They're in secondary markets where the capital to either build these structures or to acquire or renovate them comes from [section] 1031 exchanges. Do you want to cut off a capital source to that kind of housing?"

Todd R. Pajonas of Legal 1031 Exchange Services LLC said that smaller exchanges create a stable inventory of affordable housing for working families.

"Section 1031 encourages turnover and investment of fresh capital in these properties, improving neighborhoods and providing decent places to live," Pajonas said. He added that studies have shown that section 1031 buyers invest more capital in replacement properties than do other buyers.

Ripple Effects

Given the large number of jobs that like-kind exchanges create, imposing limits on section 1031 would have serious employment consequences, practitioners say.

According to Goldstein Baker, higher-valued commercial real estate exchanges provide a vast job market for a range of positions, including contractors, skilled and unskilled blue-collar workers, lenders, real estate brokers, qualified intermediaries, appraisers, architects, and landscapers. "The income earned generates tax revenue and consumer spending, furthering the economic impact," she said.

"You have an entire QI industry and an entire Delaware statutory trust industry built on section 1031, plus the ancillary effects on things like the banking industry and real estate brokerage," said Rappaport.

Restricting section 1031 would cost a lot of jobs, Rappaport said. "Does the administration foresee that? Are they content with lost jobs being collateral damage?"

James T. Walther, also with Legal 1031 Exchange Services, said the proposal would hurt employment growth in related industries, like construction and insurance, and have a chilling effect on real estate. "Why limit a pro-growth provision during a period of economic recovery?" he asked.

"Why propose additional reform when the dust still hasn't settled from the last major tax reform?" Walther said, referring to the Tax Cuts and Jobs Act's amendment restricting section 1031 to real property. "Taxpayers need consistency in the code."

Walther said he expects real estate coalitions and related industry groups to vehemently oppose any further proposed changes to section 1031. “The administration should continue to explore other options, including closing actual loopholes in the code and its ongoing efforts to increase IRS collection and enforcement efforts,” he said.

Off the Mark

Pajonas said he doubts the proposal would bring in the kind of revenue that the administration anticipates.

The measure could actually hurt revenue, Pajonas said, because it is based on an incorrect assumption that taxpayers wouldn’t change their behavior if the ability to defer capital gains tax using a section 1031 exchange is restricted. “Most taxpayers would likely hold on to their investment real estate for a longer period of time instead of selling and recognizing a capital gains tax,” he explained.

The longer holding period would slow the real estate market, resulting in less tax revenue collected from transfer tax and mortgage tax, as well as taxes paid on the income earned by the professionals and companies involved in those sales, Pajonas said.

“If the additional proposal to increase the capital gains tax rate to 43.4 percent is enacted for taxpayers earning over $1 million, it would compound the reasons for real estate investors to hold their properties,” Pajonas added. “Once a capital gains tax rate goes over a certain pain threshold, most investors will refuse to sell.”